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Macroeconomic policy questions: commodities

World commodity trends and prospects

Note by the Secretary-General

The Secretary-General has the honour to submit to the General Assembly, as requested in its resolution 51/169 of 16 December 1996, the attached report, which was prepared by the United Nations Conference on Trade and Development.

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Annex

Report by the United Nations Conference on Trade and Development on world commodity trends and prospects

I. Introduction

1. During 1985–1997, primary commodity prices experienced one of the least favourable trends in recent decades. With the onset of the Asian crisis in mid-1997, the prospects of many commodity markets have also become even more uncertain. But commodity exports continued to constitute a major source of foreign exchange earnings for a large number of developing countries. Therefore, the sustained development of these countries is very much dependent on the successful realization of the potential of this sector.

2. Conscious efforts by these countries to improve the productivity of their commodity production and to identify and exploit the emerging opportunities, particularly in non-traditional areas, are a prerequisite for many of them to escape from further marginalization.

3. After reviewing recent developments in the commodity economy, including the changes in the international environment, which may influence deeply its prospects, the present report examines a number of policy measures that could be taken by the developing countries and associated international cooperation and support.

II. Recent developments

A. Prices and terms of trade

4. During 1985–1997, primary commodity prices[1] experienced one of the least favourable trends in recent decades. In current dollar terms, the combined index of non-oil primary commodities registered an increase of a mere 2.2 per cent annually, which corresponded to a yearly decline of 0.5 per cent in real terms. The most pronounced declines in real terms were observed for all the major tropical beverages, coffee, cocoa, and tea. Real prices of metals were also weak, in particular those of tin and tungsten, while groundnuts among the oilseeds, hides and skins, wool and jute among the agricultural materials also suffered sharp declines in terms of trade during those years. Thus, in spite of some recovery during the 1990s when the general commodity price levels recovered both in current and real terms (at annual rates of 4.2 per cent and 2.8 per cent, respectively, during 1991–1997), they still remained very depressed by past standards.

5. A particular feature about commodity prices during the current cycle is how little they have responded to the recovery in industrial demand during the past year. Thus, with the exception of the prices of tropical beverages, in particular coffee and tea, the prices of the other commodities either declined or rose only marginally. These price developments during the recent economic recovery contrasted sharply with those prevailing during the previous comparable recovery in 1994. Thus, while growth of real gross domestic product (GDP) in the developed countries, at 3 per cent annually, was the same in both 1994 and 1997, the price in current dollars of agricultural raw materials increased by 14.6 per cent in 1994 but actually declined by close to 10 per cent in 1997. Similarly, while the prices of ore and metals rose by 13.4 in 1994, they were only 3 per cent higher in 1997 as compared to 1996.

6. The reasons for these discrepancies seem many. First, many commodities appeared to be in ample supply, a situation brought about in many cases by previous and temporary high levels of prices. Second, inflationary tendencies in many developed countries were very subdued during the current phase of the expansion, and thus did not provide a stimulus to speculative buying of commodities. The more subdued prices movements during the recent past also reflected the strength of the United States dollar, which rose in effective terms by 6.5 per cent in 1996 and 7.8 per cent in 1997 after years of relative stability during the first half of the 1990s.[2]

B. Global economic environment: initial effects of the Asian crisis

7. The problems faced by commodity markets are compounded by the adverse effects of the crisis in East Asia, which have already become apparent during recent months. In fact, many of these fast-growing economies in East Asia had become major markets for a wide range of commodities, including metals, agricultural materials, high-valued foodstuffs, and energy supplied by other developing countries. Many among them are also major commodity suppliers.

Table 1
Monthly indices of market prices of selected primary commodities
(United States dollars, June 1997=100)

	December 1997	*January 1998*	*February 1998*
Copper	67	65	64
Sawnwood	67	57	66
Rubber	67	64	71
Wool	81	74	73
Jute	74	74	75
Nickel	84	78	76
Zinc	82	82	78
Lead	86	86	84
Cotton	92	92	92
Aluminium	98	95	93
Tin	99	94	94
Rice	83	93	94
Hides and skins	103	94	95
Petroleum	96	84	79

Source: UNCTAD, *Monthly Commodity Price Bulletin*, March 1998.

8. The financial crisis, initially confined to Thailand, Malaysia, Indonesia and the Philippines, started to spread to a number of other emerging markets. The Republic of Korea, in particular, was thus seriously affected toward the end of 1997. The export performance of the East Asian countries, most notably the Association of South-East Asian Nations countries, weakened markedly in 1995–1996 as activity in their major trading partners slowed down. This, combined with excess supply in electronics commodities, led to considerable declines in export earnings. The external situation was then aggravated by a

loss of competitiveness, due partly to high domestic inflation and partly to the appreciations of the United States dollar to which currencies in the region were pegged.

9. A precise assessment of the impact of the crisis on the rest of the world is difficult, first because of the rapid and significant changes in the economic and financial situations in many of the countries concerned. It is also difficult because of the lack of knowledge about the exact course of policy adjustments to be adopted in other regions. What is probable, however, is that a large amount of the coming adjustment will take place in terms of changes in trade flows. With the expected declines in demand in most of East Asia, their imports are expected to be much reduced. An export drive on the part of the Asian countries can also be expected. This will be much helped by the large devaluations of their currencies during recent months.[3]

10. What is of relevance in the context of commodity market prospects is the fact that many of the countries in the region are also major exporters of commodities. For example, the region is an important source of supply of vegetable oilseeds and oils (Malaysia, Indonesia); coffee (Indonesia); natural rubber (Thailand, Indonesia, Malaysia, Viet Nam); bananas (Philippines); tea (Indonesia); cocoa beans (Indonesia, Malaysia); tin (Malaysia, Singapore, Indonesia); and copper (Indonesia). On the other hand, the recent rapid expansion of the economies in East Asia had led to a significant rise in their import demand for commodities. The importance of this market can be gauged by the fact that the combined GDP of the developing countries in the region amounted to about one third of that of the United States of America or Western Europe. In general, the potential for commodity import into East Asia had been high since the levels of consumption of a wide range of commodities, including foodstuffs, agricultural raw materials, minerals and metals, were relatively low by world standards. The energy and materials-intensive pattern of their economic development had been instrumental in raising their levels of consumption of agricultural raw materials, minerals and metals during the long years of fast economic expansion, much of which was imported. But domestic supply of essential commodities had not kept pace with the fast growth of demand. This situation prevailed not only in foodstuffs and other agricultural products but also in minerals and metals despite intensive efforts at exploration and development in countries with geological potential. For example, the bulk of cotton consumption in the major producers of textiles and clothing in the region was imported from abroad. The region's share of world consumption of metals and minerals, on the other hand, approximately doubled during the decade from 1986 to 1995.

11. Asian demand has also been adversely affected by financial factors, especially the lack of ready trade credit because of the fragility of the regions' banking systems. On the commodity supply side, the financial crisis has prompted many regional producers to increase their output. However, it appears that the sharp devaluations of the currencies in the region have not been of immediate benefit to many local exporters, because in some instances exports have been much rationed to secure supplies for the domestic markets in order to contain inflationary pressures. The collapse of many of the currencies in East Asia could also cause serious problems for crop financing in many countries in the region. Many investment projects, which have been funded by dollar loans, have lost half of their value and may face serious cash flow problems. One example is Thailand, where major milling companies have funded projects to diversify into the tourism industry.

12. Latest available information suggests that the impact of the Asian region's reduced activity, and thus demand, has already been felt in the world commodity markets. For example, the decline of metal prices was in response to the weakening of activity in the automobile and construction industries in the region. Further, the crisis in the Asia region, which accounted for approximately half of the increase in world consumption of petroleum

products during the 1990s, largely contributed to the recent fall of world crude oil prices. And in the food sector, declining incomes may cause change in consumption patterns towards more traditional diets, thus reducing the imports of high-value products. As to the supply side, there may be a switch in input mixes used in production and investment in favour of domestic products, although available statistics do not yet reveal significant changes.

13. Recent price declines, some of them very pronounced, were observed for many commodities, which altogether accounted for about one third of non-oil primary exports of the developing countries. Of course, factors other than the crisis also contributed to these declines. However, there is no doubt that the prices of agricultural raw materials, metals (in particular copper and nickel) and to a somewhat lesser extent energy products have been adversely affected by the depressed demand stemming from the crisis. As can be seen from table 1, the falls in the indices of prices were quite widespread, and affected both agricultural commodities and the metals. Among the metals, copper prices declined by 36 per cent between June 1997 and February 1998, nickel by 24 per cent, zinc 22 per cent, and lead 16 per cent, while among the agricultural materials sawnwood prices fell by 34 per cent, rubber 29 per cent, wool 27 per cent, and jute 25 per cent. But while the prices of the agricultural commodities appeared to have more or less stabilized, albeit at lower levels than those prevailing in mid 1997, most metal prices and that of petroleum continued to deteriorate up to February 1998 (recent developments in major commodity markets, including those especially affected by the crisis, are examined below).

14. These prices declines can be expected to affect adversely a large number of developing countries that are highly dependent on commodities for their exports. This is illustrated by the data compiled in table 2. Thus, the potentially affected developing countries are located in all regions: 12 in Africa, 8 in Latin America and 18 in Asia.

Table 2
Developing countries with commodities experiencing price declines during June 1997–February 1998

	Commodities[a]													
Country	*1*	*2*	*3*	*4*	*5*	*6*	*7*	*8*	*9*	*10*	*11*	*12*	*13*	*14*
Algeria														B
Angola														A
Bahrain														A
Bolivia		C									B			
Brunei Darussalam														B
Cambodia		B												
Cameroon		B							C					B
Central African Rep.		B												
Chile	B													
Colombia														B
Congo, (Dem. Rep. of)		C												A
Côte d'Ivoire		B							C					
Ecuador														B
Egypt									C	C		C		B
Ethiopia													B	
Gabon		C	C											A
Indonesia		B	C											B
Iran (Islamic Rep. of)													C	A
Iraq														A
Kuwait														A
Libyan Arab Jam.														A
Malaysia		C												C
Mexico														B
Myanmar		B	C									C		
Nigeria		C	C											A
Oman														A
Papua New Guinea	B	B												B
Paraguay									B					
Peru	B						C							
Qatar														A
Saudi Arabia														A
Sudan									B				C	
Swaziland		B												
Syrian Arab Rep.									C				C	A
Togo									B					
Trinidad and Tobago														B
Uganda									C				C	

Country	Commodities[a]													
	1	*2*	*3*	*4*	*5*	*6*	*7*	*8*	*9*	*10*	*11*	*12*	*13*	*14*
United Arab Emirates										C				A
Tanzania, United Rep of									B					
Venezuela										C				B
Viet Nam												C		B
Yemen														A
Zambia	A													

A: Accounting for over 50 per cent of total exports
B: Accounting for between 10 and 50 per cent
C: Accounting for less than 10 per cent

Source: UNCTAD, *Monthly Commodity Price Bulletin*, March 1998, and UNCTAD, *Handbook of International Trade and Development Statistics 1995*.

[a] Commodities indicated altogether accounted for at least 10 per cent of total exports of the countries concerned. Commodities, by number of column above, with percentage price change June 1997–February 1998 indicated in parentheses ( ), are:

1 Copper (-36)
2 Sawnwood (-34)
3 Rubber (-29)
4 Wool (-27)
5 Jute (-25)
6 Nickel (-24)
7 Zinc (-22)
8 Lead (-16)
9 Cotton (-8)
10 Aluminium (-7)
11 Tin (-6)
12 Rice (-6)
13 Hides and skins (-5)
14 Petroleum (-21)

C. Main features of recent developments in selected commodity markets

1. Foodstuffs

15. Supplies remained plentiful for many foodstuffs. In particular, the sugar market continued to suffer from refinery overcapacity, and supplies remain plentiful thanks to surges in refinery activities. More generally, large new state-of-the-art sugar refineries have been erected in East Asia, and smaller plants have also been built in other parts of the world as both producers and importers of raw sugar have tried to augment the value added content of their processing operation. Many of these plants, however, will not be viable, and have either to be shut down or run at a loss if the difference between white and raw sugar prices narrows significantly, as it has recently. On the whole, sugar remains in plentiful supply on the world market, and there is an estimated excess of exportable sugar over estimated import demand.

16. Supplies of coffee are also plentiful thanks, for example to the bumper Brazilian harvest. The International Coffee Organization has forecast a global surplus, the first such to occur since 1992, and thus coffee stocks will probably remain high. Moreover, recent trends also suggest significant expansion of production over the longer term as recent near record prices, following the 1994 boom, have encouraged investment by coffee growers worldwide. Yields in coffee plantation can also be expected to improve following the wave of spending on farm maintenance, which was also boosted by cheap fertilizer costs. However, the effects of the increased plantings proper will be felt only in the longer term. Consequently, the pattern of boom-bust for coffee is not about to disappear, hence the Association of Coffee Producing Countries plan to regulate supplies. Meanwhile, growth of demand is expected to remain sluggish and can be expected to be adversely affected by the East Asian crisis, and the coffee market is still under the threat of crop failures. In particular, El Niño may still have a negative impact on production in the near future.

17. As for cocoa, prospects remain poor since for the immediate future consumption growth could be adversely affected by recent high prices. However, the recent above average rate of growth of chocolate consumption, especially in North America, if sustained, would provide a boost to the cocoa market. Prospects also depend on whether the European Union will finally allow all member countries to use cocoa butter substitutes, a decision that could displace up to 200,000 tons of cocoa a year. Currently, El Niño's impact on cocoa production appeared to have been less damaging than expected, but the situation remains very uncertain. Indeed, it has been estimated that a deficit of up to half a million tons could lead to a stock depletion well below the critical level of 30 per cent of consumption.

18. For other beverages, while current stocks, such as those of tea, are low, there is the ever-present threat of much expanded production globally in the years to come. Thus, future production is critical in determining prices in a market becoming more supply- than demand-driven. In fact, a serious crop setback in any one of the major producers – India, Kenya or Sri Lanka – could lead to a large price hike. The prospects are for intense competition for export markets, including in particular that of the Russian Federation. On the demand side, a welcome boost can be expected from the results of current research vaunting the health benefits from black tea consumption. 1997 was a good year for tea growers, as prices rose in response to buoyant demand from the Russian Federation. Prices were also boosted by sharply reduced supplies from Kenya due to drought. For the near future, El Niño remains a potentially disruptive influence on production. The most promising development on the demand side remains the surge in consumption in India. Nevertheless, demand can be expected to remain sluggish elsewhere, including the United Kingdom of Great Britain and Northern Ireland, Western Europe in general and the United States. The danger remains that

sustained price rises could encourage production increases, especially by smallholders. Prospects appear to be continued marginal oversupply; this, combined with low stocks and sustained demand, especially in Eastern Europe may help to sustain prices.

Agricultural raw materials

19. For industrial materials, prospects depend critically on demand conditions in the Asian crisis countries, and the prices of natural rubber, in particular, have weakened markedly in recent months. Rubber consumption depends to a very large extent on the pace of car production and sales. In fact, up to 70 per cent of all natural rubber is used in the production of car tyres. Natural rubber demand is particularly exposed to disruption by the crisis in East Asia since the region is today the biggest user of the commodity, consuming about half of the world's supplies. The East Asian countries' recent high growth has been fuelling natural rubber demand in recent years. The prospects for the natural rubber market are thus particularly worrisome, with the danger that the effects of the crisis may spread to other regions, in particular Latin America, where Brazil is the region's fastest growing consumer of natural rubber. On the supply side, however, the currency devaluations of the major natural rubber producers, i.e., Indonesia, Malaysia and Thailand, may stimulate output since the devaluations have increased growers' returns despite declines in dollar prices. Prospects are for continued oversupply, which in mid-1997 already had almost prompted support buying on the part of the International Natural Rubber Organization (INRO). In all likelihood, the natural rubber market will thus be in surplus for a third year in a row. INRO may intervene in the market to prop up prices since it has the funds to buy natural rubber to protected internationally agreed floor prices, an action that may well take place during the current phase of weakness in the market. In addition, El Niño may reduce East Asian rubber production, at least in the short term.

20. The impact of the Asian crisis can also be determinant for the cotton market. Thus, for this market the impact of the Asian crisis, with the sharp devaluations of the currencies of the countries in the region, can be expected first to reduce local producers' earnings, but it will also tend to boost the competitive edge of the region's textile industries. The East Asian region is a major consumer of cotton, accounting for about two thirds of total world demand. Moreover, the cotton market has continued to suffer from the global overcapacity of the polyester sector, and it can be expected that competition from synthetics will continue to dampen the growth of cotton consumption over the long term. Cotton prices had been falling since August 1997, and in February 1998 stood some 8 per cent below mid-1997 levels.

21. Similarly, with such large consumers as Japan and the Republic of Korea, the East Asian countries altogether accounted for about half the global consumption of wool. Thus, the financial crisis in East Asia does not augur well for the wool market for the foreseeable future, and wool prices have already declined by 27 per cent between June 1997 and February 1998. As in the case of cotton, wool is also suffering from the encroachment of synthetic fibres. Added to the price-depressing factors is the expected continuing disposal of wool from Australia's stockpile. Counterbalancing these trends, however, are factors that will contribute to lower global supply, such as falling sheep numbers and better returns from alternative farming activities.

22. The decline in timber prices has also been among the most pronounced, and reflected in the main the protracted weakness of demand in Japan (see table 1). The slump in construction activity in East Asia, together with the large currency depreciations of the major producers in the region, can be expected to increase timber supply for the export markets.

Minerals and metals

23. With few exceptions, prices of base metals experienced continued weakness during recent months. Some of the declines, especially those of the prices of copper, nickel, zinc and lead, were particularly large (see table 1) as the depressed demand for those commodities has been compounded by problems of oversupply. In particular, copper production capacity in the major producing countries has been expanded significantly in recent years, and the reduced demand from the East Asian countries has been an additional adverse factor behind the recent price slump. In fact, taken together, the five Asian countries accounted for as much as one fifth of the increase in the value of world imports of copper during 1991–1996.[4] On the other hand, the reduced copper prices can be expected to have very adverse effects on the export earnings of many developing countries. Indeed, copper exports accounted for relatively large shares in total earnings of many of those countries, including Chile, the Democratic Republic of the Congo, Papua New Guinea, Peru and Zambia (see table 2). Similarly, zinc prices have experienced pronounced drops, and the prospects of the zinc market remain very uncertain since they depend largely on the car and construction industries, which have been adversely affected by the sharp drop in economic activity in East Asia. Furthermore, several new production projects are expected to come on stream, with large capacity increases expected in Latin America as well as Australia, and production capacity is also expected to expand in both Chile and Peru. The outlook for the nickel market is also dependent on global economic growth, and thus on future levels of activity in East Asia, since – in common with lead and zinc – nickel is heavily dependent on a single industrial activity, namely stainless steel, which alone accounts for about 60 per cent of world consumption.

24. The dollar prices of crude oil have also been steadily declining since November 1997, and can be expected to remain subdued in the near future. Crude oil stocks have been rising following a warmer than average winter, and the globally weak demand has been compounded by the slowing of demand growth in the countries adversely affected by the East Asian crisis. The impact of the 10 per cent rise in Organization of Petroleum Exporting Countries production quotas agreed in November 1997 remains to be seen. Added to the uncertainties in oil market outlook is the rise in Iraq's output following the expansion of the United Nations oil-for-food programme in February 1998.

D. Effects of El Niño[5]

25. The climatic phenomenon known as El Niño, which usually occurs every 2 to 7 years with varying degrees of intensity and duration, involves an occasional warming of the surface waters in the Central and Eastern equatorial Pacific Ocean, as a result of which the atmosphere heats up and conditions became ripe for excessive rainfall. The current El Niño was considered by many observers as being the most severe to occur this century. It started in March 1997, but its most intensive impact was expected to have been felt between December 1997 and the first quarter of 1998. In general, the phenomenon usually affected agricultural activities, but the associated changes in ocean surface temperatures also affected marine ecosystems. Thus, some of the phenomenon's most dramatic impacts in recent decades had been felt by the ecosystems of the tropical Pacific Ocean. In particular, the region off Peru and Ecuador is the most vulnerable since, for example, the Peruvian *anchoveta* suffered a major stock depletion during both the 1972–1973 and 1982–1983 El Niños. The ensuing stock recovery since then has been much threatened by the current El Niño. Elsewhere, the unusual weather pattern due to El Niño may adversely affect the complex life cycle of the fishery resource processes globally.

26. On the continents, El Niño had been causing severe floodings and weather-related damages in Latin America and drought in Asia, as in the 1982–1983 El Niño. More recently, it also caused severe drought in southern Africa. Although it is difficult to quantify or forecast with any degree of exactitude the effects of the phenomenon on agricultural production, much of the current concern involves the extent of the damage expected of the cereal crops planted for the 1998 harvest.

27. In agriculture, Latin America is usually the most exposed to El Niño's adverse impact. For the current season, crops have already been affected by drought in Central America and the Caribbean. Moreover, significant reductions in planted area for wheat due to a wetter than normal winter can be observed in both Argentina and Brazil. But other developing regions are also exposed. Thus, serious drought in Indonesia, the Philippines, Thailand can be expected to delay rice-planting operations and thus lead to a switch to early maturing but lower-yielding varieties. In Africa as well, there is considerable concern about the prospects for the 1998 coarse grain crop, especially in South Africa, which had also suffered a serious El Niño-related drought in 1991–1992. And in South-East Asia, coconut and palm yields can also be expected to decline because of lower-than-average rainfall. Tropical beverage production, with the exception of tea, may also suffer. In particular, the Asian coffee crop may be threatened by drought, that of Brazil by excessive rainfall. And global cocoa shortages are also in the offing if the effects of the current El Niño turns out to be as severe as in 1982–1983.

Table 3
Primary commodity trade, by main groups and regions
(Billions of dollars and per cent shares of world total)

	1986–1987		*1989–1990*		*1994–1995*	
	Value	*Share*	*Value*	*Share*	*Value*	*Share*
Exports						
Developing countries	115.1	31	148.6	29	199.2	30
Africa	17.6	5	19.4	4	19.9	3
America	43.3	11	55.3	11	71.1	11
Asia	50.6	13	68.9	13	103.7	16
Developed countries	242.7	64	348.1	67	429.8	65
Imports						
Developing countries	89.2	21	129.6	23	189.3	27
Africa	15.7	4	19.5	3	21.2	3
America	14.3	3	19.3	3	31.6	4
Asia	56.3	13	86.5	15	131.7	19
Developed countries	302.0	72	412.0	72	490.3	69

Source: UNCTAD database.

III. Commodity dependence: overview of characteristics and policy options

A. Overview

World trade in commodities

28. World trade in primary commodities has grown more slowly, and makes up a smaller share of total world trade than manufactured products. In the mid-1990s, primary commodities accounted for just over one fifth of total world trade, a decline from over 40 per cent in 1980. However, commodity exports continued to constitute a major source of foreign exchange earnings for a large number of developing countries. In all, over half of total export earnings are generated by commodities in half of the developing countries in Latin America; three out of five countries in Africa; and one in four countries in South, East Asia and Oceania. Thus, the commodity sector also remained the major source of output and employment in most of the developing world. In fact, for the large majority of developing countries, with the exception of the newly industrialized ones, primary production still accounts for about one third of domestic output. Of course, this share is even higher for the poorer countries, including the least developed countries.

29. The major markets for most primary commodities remained the developed countries, which account for about 70 per cent of global world imports of commodities. It is true, however, that the developing countries share has increased significantly during recent years, a reflection of the fast rate of expansion of imports into the fast-growing economies of South and East Asia. Thus, at almost 20 per cent in the mid-1990s, Asia's share had increased by about 50 per cent over its level of 13 percent a decade earlier (see table 3).

30. As the largest market for primary commodities, the developed countries are also the dominant suppliers of these products, accounting for over half of world exports of commodities in the mid-1990s, with North America accounting for about 15 per cent and Western Europe one third. The nine most important exporters of agricultural commodities are all from the developed world. The dominance is particularly marked in exports of cereals: nine developed countries account for two thirds of the world's total exports of these commodities. For the developing countries, commodity exports amount to just over 40 per cent of the world total, with about one fifth accounted for Asia, 10 per cent by Latin America and somewhat more than 6 per cent by Africa.

Declining importance of primary commodities

31. However, in both developed and developing countries (as a group), the importance of commodities in terms of total trade has steadily diminished over the years. But these declines in share of commodities in world trade do not reflect an absolute diminution in the value of commodity exports. In fact, these exports have about doubled in value, both for the world as a whole and for the developing countries taken altogether during the decade from the mid-1980s to the mid-1990s. But in the meanwhile, total world trade rose by more than two and a half times during the same years, and thus the declines in commodity trade's share are the consequence of the more sluggish pace of expansion of these exports compared with that of global trade, in particular that of manufactured products.[6] In the case of the developed countries, the commodities share in total exports declined from about one fifth in 1980 to below one sixth in the mid-1990s. In the developing countries, on the other hand, the corresponding share has dropped from about 20 to just about 15 per cent during the same period. But for Africa, the share even rose slightly, from 21 to 23 per cent. Thus, many

African countries, especially the least developed among them, remained highly commodity-dependent, with weak supply capabilities, and were therefore unable to exploit the potential benefit from world trade expansion, so that the region's intra-trade remained small by other developing region's standards.

Erosion of preferences

32. Certain recent developments, moreover, are of particular concern to the poorer among the developing countries, especially those in Africa, which aspire to diversify their economies. In particular, the erosion of trade preferences that stems from the cuts in most-favoured-nation tariffs as a result of the Uruguay Round negotiations will affect negatively the diversification programmes of these countries. This concern is particularly important for the least developed countries because of their low level of industrialization and their high degree of export concentration in a few commodities. Trade preferences are very important to them since most of their exports are admitted free of duty and in general are not restricted by quotas or ceilings. It should be noted, however, that the Uruguay Round only reduced but did not eliminate these tariff preferences. It should also be added that the challenge posed by the United States and several countries in Latin America to the European Union's banana import regime may lead to the dismantling of Africa, Caribbean and Pacific trade preferences.

Instability of earnings

33. Among the perennial problems facing producers of commodities is the excessive instability of the prices of many commodities. The consequent instability in export earnings has adverse effects on domestic savings and government budgets, as well as on the import supply of intermediate and capital goods and hence on investment and growth. In the recent past, instability (as measured by average deviations from trend) has been particularly pronounced for many across the whole spectrum of commodities, in particular coffee and cocoa among the tropical beverages; sugar among food; many vegetable oils; wool, jute, hides and skins; rubber among the agricultural raw materials; and nickel, manganese ore, zinc, aluminium and copper among the minerals, ores and metals. The reasons for the observed instability are many. There is, for example, the inherent boom-bust investment/production cycle for many tropical beverages because of the long gestation period between new planting and production. For other agricultural commodities, vagaries in the weather tends to be the main cause, while changes in industrial activity and hence demand tend to cause instability in metals prices. The surge in recent years in the flows of speculative capital into and out of commodity markets for financial assets has tended to accentuate commodity price instability during recent years. Producers, of course, can have recourse to managing price risks through hedging strategies in futures markets. But the abuses of these markets can entail huge losses, witness those disclosed by Sumitomo Corporation in connection with trade of copper-related financial instruments. In principle, however, these futures markets can provide an essential service.[7]

B. Diversification experiences

34. Diversification has been the main conventional remedy for commodity-dependent economies. Recent developments in the world commodity economy, as well as new research and policy analysis, suggest that diversification strategies deserve some rethinking. For example, it is now recognized that diversification performance is more effectively influenced at the micro- and meso-levels.[8] This does not imply that government and institutional

measures are no longer required, but that they need to reflect developments and economic exigencies at the level of enterprises, whether farms, mines or business firms.

Enterprise-level diversification patterns

35. Firms in developing countries tend to diversify more broadly than those in developed countries, principally because their skills are often of a general nature and not product specific. Often, developing country firms tend to compete on the basis of price and reliability at the lower or middle levels of product markets.

36. Diversification has also frequently been oriented to processes, as opposed to being bound to commodity types. Firms producing tinned fruit products for exports, for example, moved into processing quite unrelated foods, such as fish, using established canning capacity technologies and marketing channels. In some cases, commodity sector development and diversification has benefited from an expansion in concentric rings. Several commodity producers in South-East Asia, Latin America and Africa, for example, garnered more distant and sophisticated export markets in Organisation for Economic Cooperation and Development (OECD) countries after they had established a reputation for quality, reliability, value-for-money, or a brand name in local and subregional markets. For instance, some of the large *robusta* coffee producers – Brazil, India and Indonesia – are currently exploiting this path by investing in marketing drives to promote domestic consumption. The longer-term plan is to enter subregional and ultimately world markets with value-added coffee products once quality and branding are firmly established in the home market. A drawback of such strategies, however, might be that demand characteristics of domestic markets – which might accept lower-quality products – could weaken the economic incentive to upgrade into higher-quality product niches.

Global marketing chains, clusters, networks as channels for diversification

37. Beyond the role of individual firms, globalization has re-emphasized and modified the role of the global marketing chains that have characterized the commodity economy for many decades. The structure and composition of trading channels continue to play a crucial role, and understanding their dynamics can enable firms to position themselves more advantageously at the appropriate link in the chain.

38. In many commodity markets, a major share of global trade flows is handled by a small group of transnational firms who source products globally, and thus apportion export shares of firms and countries. It can be difficult for newcomers to establish themselves independently and take a share of the market. Example include coffee where 70 per cent of trade is handled by four international firms, or some processed fruit or vegetable markets, where a small number of transnationals are predominant.

39. Nevertheless, a noticeable number of processing or trading firms situated in developing countries have recently begun entering world marketing chains, as flexible specialization has lead to a dispersion of supply and processing facilities across the globe. Some developing countries have succeeded in delivering to such chains not just raw materials but processed commodities, and in creating industries based on locally available resources, with backward linkages. Examples include successful poultry producers and processors from Brazil and Thailand, or gemstone polishing in several developing countries. A development that has gone unnoticed is the emergence of a considerable number of developing countries, who have become major exporters of high-unit value fresh fruit, vegetables or cut flowers in a short span of time.

40. The relative strengths of exporters in world markets are a function of market development on the one hand and the characteristics of the commodity involved on the other. Diversification into expanding product markets – typically with annual growth rates of world imports exceeding 10 per cent – into highly income-elastic products, the demand for which exhibits rapid growth, or into dynamic regions, offer the easiest avenue to upgrading the producing economy's position in the commodity chain.

41. Apart from market and product characteristics, three different factors can be isolated that have supported a better positioning of developing country firms in global marketing channels, and hence created the scale of demand and rates of profitability prerequisite to successful diversification, be it horizontal or vertical.

42. First, commodity-based clusters are probably the best guarantee for backward linkages since they are anchored in the resource base of the host economy. At the same time, such clusters of enterprises situated in proximity of one another and sectoral networks among enterprises can enhance world market entry by facilitating access to and promotion of information regarding markets and technology. They can also reduce overhead costs by mutual implementation of contracts, joint purchase of inputs, jointly funded ancillary services or joint marketing initiatives. Such clusters have some success in such countries as Brazil, but they have not developed sufficiently in many other commodity dependent countries.

43. Second, the role of "soft" or social factors in ushering in commodity-sector diversification should not be underestimated, but the opportunities to benefit from them have not in general been actively pursued. Producers and traders tend to develop "personalized" and repetitive relationships founded on personal commonalities, such as gender, kinship, ethnicity, religion and caste, which create mutual reliance or trust. Such ties can serve to reduce risks and transaction costs by guaranteeing delivery, ensuring quality control, procuring reliable information, minimizing tedious bargaining processes or providing access to informal finance. Examples of such soft channels include the export market for tropical vegetables from Kenya to the United Kingdom which was the basis for an expanding off-season vegetable trade from Eastern African countries into the European Union; the exports of Caribbean foods to ethnic grocers in the United States; or marketing of African and South-East Asian specialities to many OECD markets.

44. Third, diversification in commodity reliant economies can find support in the innovations in information technology, such as electronic trading and information, available on the Internet. Thus, commodity processors and traders in developing countries can tap price and business opportunity information, and identify points of entry to and opportunities for effective participation in commodity chains. Dependence on the large players in international commodity markets can hence be replaced by groups of new entrants from developing countries.

Finance for diversification

45. Finance remains a major constraint in many developing countries. Sources of finance have varied widely among countries. In some instances, countries heavily dependent on a single mineral or agricultural commodity export have established diversification funds by levying a cess on exports. The proceeds are devoted to funding research or extension services; this has generally been channelled to promoting the upgrading or exports of that particular commodity or to agricultural diversification in general. Country examples include Chile, Colombia, India, Papua New Guinea and Uganda.

46. Enterprise-level diversification in developing countries has often been financed through "organic growth", i.e., reinvestment of profits, through loan-based investment. Over the past decade, the emergence of stock markets and broad-scale privatization of public enterprises has provided new sources of capital and led to diversification through acquisitions.

47. Foreign capital is another source of diversification funding. Foreign direct investment (FDI), joint ventures and strategic alliances have begun contributing to vertical diversification through the establishment of processing plants in developing countries. Recently, FDI from developing countries is emerging as a new source of finance, notably for neighbouring countries. A fair share of such commodity-relevant foreign investment has been directed into agribusiness and foods, mining, metals and construction materials. As with intra-firm growth patterns, developing country FDI typically makes use of product-specific knowledge or familiarity with markets and regulations.

Role of Governments in conjunction with trade or industry associations

48. Governments, in conjunction with trade or industry associations, are indispensable in developing commodity production and trade. In defining policies and programmes, the specifics of each commodity need to be taken into account, since the dynamics of production and trade flows vary considerably among different subgroups of commodities, and among subsets within each group. Restructuring of the public enterprise sector and the dismantling of commodity-related trade authorities, such as marketing boards, over the past decade has often occurred without putting in place alternative institutions to handle production and trade. Successful commodity diversification, however, requires that the enterprise sector be linked via professional associations and information flows to local and central governments. Business associations and governments can also support the commodity sector by lobbying and identifying market opportunities and channelling information flows to the enterprise sector. Local-level governments have a role to play in providing physical, social and technical infrastructure to clusters and networks.

49. An interesting example of such interactive private-public modalities are the generic marketing drives undertaken by governments and sectoral associations in Colombia to market coffee or in Thailand to promote silk.

New assessment

50. An important emerging finding is that reliance on commodity exports is not a priori and in all cases a disadvantage. The developmental potential of the commodity economy depends on the commodity's product characteristics, market structures and development, and marketing strategies. Moving away from commodities to manufactures and vertical diversification is not always the economically most efficient option. A case in point are exports of high-value food commodities in fresh and chilled form – as opposed to processed form – which can fetch high unit values and contribute more to net export revenues than processing. This benefit is predicated on identifying product markets that are expanding due to absolute growth or income elasticity, and on a certain degree of harmonization among suppliers to avoid fallacy-of-composition effects.

C. Policy options

51. The developing countries have not escaped the consequences of globalization and liberalization, which have profound implications for the future development of their

economies. Many countries, especially the poorer among them, risk being even more marginalized unless they can adapt to the new competitive international environment, the main features of which are the utilization of new technology and production processes to increase efficiency. Recent experience has shown that supply-side factors have emerged as key impediments to many developing countries' improved participation in international trade.

1. Domestic aspects: information infrastructures

52. Inadequate and ill-maintained physical infrastructure, including telecommunications, storage, and road, rail and/or air transport facilities, has limited the scope of supply-side response of developing countries, especially the poorer among them. In particular, taking advantage of emerging market opportunities requires the existence of information systems and communication networks for efficient product movement in order to be able to react flexibly to rapidly shifting market demand. The budgetary situation in many countries limits public investment in this area. Incorporating needed infrastructural developments into projects and encouraging the private sector to invest in building and operating these infrastructural facilities would play a significant role in this domain.

53. Cooperation and close collaboration between business and government with a view to facilitating the flow of information between the public and the private sector has often been instrumental in the success of many developing countries.

2. Agenda for commodity-based diversification

54. A proactive agenda for commodity-based diversification would need to be based on appropriate policies and measures by commodity-dependent countries themselves, supported by a favourable international environment .

Recommendations for commodity-dependent countries

55. Action by commodity-dependent countries themselves can aim at three main objectives, namely, (a) to obtain improvements in the multilateral trading system that are conducive to commodity-based development, (b) to create an enabling domestic environment for commodity-based development and (c) to assist the enterprise sector in their pursuit to be successful in commodity-based businesses domestically, regionally, and globally.

Benefiting from the multilateral trading system

56. Commodity-dependent developing countries need a clear understanding of the Uruguay Round obligations and commitments so as to recognize the full range of options available to them in support of diversification. In this respect, the implications and ways to take advantage of the Agreement on Subsidies and Countervailing Measures merits particular attention.

Creating an enabling environment for commodity-based development

57. The following is recommended:

(a) In order to facilitate the development of the commodity sector, Governments need to ensure that property rights are clearly defined and secure;

(b) The respective responsibilities of central and local-level governments need to be delineated clearly. Local-level governments are crucial in the implementation of commodity-based development programmes. In many cases, their capacity needs to be

upgraded and measures taken to ensure that the diversification process is participatory and that all stakeholders are heard;

(c) Governments need to attach priority to the provision of physical and institutional infrastructure, especially with respect to the development of exports;

(d) In commodity-dependent countries, special efforts are needed to generate funds for the development of the commodity sector. One option is to tap the sector itself by earmarking funds which could function as venture capital to stimulate diversification into non-traditional commodities and processed products;

(e) Training of human resources is a crucial factor in development and diversification, and should include the following:

(i) Training and research on sophisticated technology that is conducive to diversification into new and more profitable processes and products beyond the current rung on the technology ladder;

(ii) Enhancement of skills at the intermediate level, which serves to improve productive flexibility and facilitates continual diversification;

(iii) Basic extension services, which are required to enable small and medium-sized enterprises and small agricultural producers to upgrade their activities above the subsistence level and diversify;

(f) Networking of training and research institutions with production enterprises has significant benefits in terms of external economies, cost-sharing and the development of centres of excellence. Such networks could be co-sponsored by central or local governments, business associations or parastatals.

Assisting enterprises

58. The following is recommended:

(a) The basic essentials for the identification of market opportunities are often lacking in many commodity-dependent countries. Training in this area would be highly beneficial for enterprises that are seeking to expand their trade horizons, as well as for government officials assisting them;

(b) With a view to expanding investment in commodity-based development in general and horizontal and vertical diversification in particular, the business community needs to take the initiative to identify specific impediments to market access and exports, formulate realistic modalities to overcome them and enlist the assistance of Governments, as appropriate;

(c) Information exchange, joint marketing and trade promotion improve the bargaining position of producers and traders. The cost of such measures may need to be shared between the benefiting firms, the developing country government, and in the case of low-income economies, the international donor community. The establishment, structure and functions of a new generation of business-oriented marketing boards might be a subject for further exploration;

(d) Enterprises may need to review the strategies they use to position themselves in the commodity chain, and to identify market opportunities based on product characteristics (niches, small batches, quick reaction, freshness, novelty, high unit value, process-based etc.). Organic products may merit particular attention in this respect;

(e) Clustering of enterprises lowers transaction costs. It can be conducive to diversification and widening the scope of commodity-based development. With the

cooperation of competent international organizations. Governments could explore natural-resource-based cluster experiences in commodity-dependent economies, distill from them factors that lead to horizontal or vertical diversification, and formulate actions appropriate for the specific conditions of the country.

Recommendations for the international community

59. The basic function of the international community is to provide a favourable international environment and supply the requisite assistance for the success of actions by the Governments of commodity-dependent countries themselves, so that:

(a) An open trading system, in particular further reductions in protectionist measures, including domestic support for agriculture and tariff escalation, is of paramount importance;

(b) Financial cooperation to facilitate the commodity-dependent countries' management of excessive fluctuations in commodity export earnings should be maintained and expanded;

(c) Technical cooperation should include training for technical, managerial and commercial staff of developing countries, in particular for quality improvements, abidance by new rules and regulations concerning international trade, and market entry;

(d) Actions by non-governmental organizations that would help in commodity-based development should also be promoted.

3. Trade finance and risk management

60. Improving the possibilities for using physical commodities as collateral for loans could significantly strengthen export financing for commodities. The warehouse receipt system is one possibility in this regard. But apart from a lack of expertise about how to structure such transactions, neither economic policy nor the legal and regulatory framework in many developing countries has been conducive to the enhanced use of commodities as collateral for trade finance. The international community can support developing countries' measures regarding trade finance by providing financial support and expertise, as well as, for example, by providing extra security at agreed warehouses, enhancing possibilities for rediscounting developing country banks and creating new sovereign risk insurance facilities.

South-South and international cooperation in trade and investment

61. Efforts must be made to promote enhanced complementarities among developing countries for taking due advantage of the emerging and diversified trade opportunities. This consideration takes on special significance given the enlarging share of developing countries as market for primary and processed exports from the developing world itself. South-South cooperation can also help to harmonize policies and rationalize supplies, thus minimizing the so-called fallacy of composition associated with commodities subject to inelastic global demand and/or to a structural surplus/overhang. In general, a very high proportion of global purchasing power, investment capital, frontier technologies and aid resources remains located in or mobilizable from the developed countries. Realistically, therefore, any durable transformation and diversification of the developing countries' commodity sector must by necessity involve trade, investment and other factor mobility, for mutual benefits, with the developed countries.

4. Multilateral trade negotiations

62. In spite of its limitations, the Uruguay Round Agreement on Agriculture has brought agriculture under comprehensive multilateral discipline for the first time. The need for further trade liberalization in the major developed importing countries has been extensively discussed in recent reports.[9] The issues remain very much alive as renewed negotiations are in the offing for the early years of the twenty-first century. Commodity-dependent countries need to formulate a proactive and positive agenda for forthcoming multilateral trade negotiations, reflecting their requirements for commodity-based development. Modalities could be sought to include financial and technical support for expanding the supply capacity of these countries as an integral part of future trade negotiations.

Notes

[1] Throughout the present report, unless otherwise specified, commodities refer to all commodities excluding fuels, i.e., the sum of agricultural primary commodities and mineral commodities, defined as Standard International Trade Classification, section 0, section 1, section 2 (less group 233, synthetic rubber, and groups 266 and 267, synthetic fibres), section 4, division 68 (all metals except iron and steel) and item 522.56 (alumina); this does not include precious metals and gemstones.

[2] The combined index of commodity prices rose by 4.1 per cent when expressed in special drawing rights but remained unchanged in dollar terms in 1997.

[3] The depreciations of East Asian currencies against the dollar have been very large. Between June 1997 and February 1998, these ranged from about 75 per cent in Indonesia to about 35–45 per cent in Malaysia, the Philippines, the Republic of Korea and Thailand. For details on the genesis and global impact of the crisis, see United Nations Conference on Trade and Development (UNCTAD), *Trade and Development Report 1998*, forthcoming.

[4] See UNCTAD, *Handbook of World Mineral Trade Statistics 1991–1996*.

[5] For more details, see FAO, *Food Outlook*, No. 10/11/12 (1997).

[6] It should be noted that the increasing break-up of production chains, whereby components of a product are assembled in different locations with semi-finished products being traded internationally at different stages of completion, would tend to result in faster increases in the trade for manufactured goods in general. However, the extent to which this may have influenced the observed rate of growth of world trade has not been satisfactorily quantified. For a detailed discussion of the issues, see WTO annual report for 1995.

[7] For a recent survey of the issues, see UNCTAD, "Examination of the effectiveness and usefulness for commodity dependent countries of new tools in commodity markets risk management and collateralized finance", document TD/B/COM.1/EG/2 (6 February 1998).

[8] For a more detailed presentation of recent research findings and these arguments see UNCTAD, "Diversification in commodity-dependent countries: the role of governments, enterprises and institutions", document TD/B/COM.1/12 (5 September 1997).

[9] See, for example, UNCTAD, "The Uruguay Round and international commodity trade and prices", document TD/B/CN.1/30 (30 August 1995).